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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

THE MOTORLEASE CORPORATION, *Petitioner*

v.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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INDEX

	Page
Opinions Below	1
Jurisdiction	2
Question Presented	2
Statute and Regulations Involved	3
Statement	3
Reasons for Granting the Writ	8
Conclusion	23
Appendix A	1a
Appendix B	22a

CITATIONS

CASES:

Adams v. *Commissioner*, T.C. Memo. 1964-286 .....20, 21
Cohn v. *United States*, 259 F. 2d 371 .....14, 17
Commissioner v. *Evans*, 364 U.S. 92 .....7, 8, 14, 15, 16, 17, 18, 19, 20, 23
Detroit Edison Co. v. *Commissioner*, 319 U.S. 98 ....9, 12
Fribourg Navigation Co. v. *Commissioner*, 335 F. 2d 15 .....2, 7, 8, 13, 14, 18, 19, 21
Hertz Corp. v. *United States*, 364 U.S. 122 .....11, 17, 18
Killebrew v. *United States*, 14 AFTR.2d 5565 ...20, 21, 22
Kimball Gas Products Co. v. *United States* 63-2 U.S.T.C. par. 9507 (W.D. Tex. 1962) 20, 21, 22
Macabe Co., Inc. et al. v. *Commissioner*, 42 T.C. No. 87 . 8, 10, 13, 18, 19, 20, 21, 22
Massey Motors, Inc. v. *United States*, 364 U.S. 92 ....7, 8, 11, 12, 14, 16, 17, 18, 19, 20, 23
Moses Lake Homes, Inc. v. *Commissioner*, T.C. Memo. 1964-289 .....20, 21
Nichols et al. v. *Commissioner*, 43 T.C. No. 13 .....20, 21
S & A Co. v. *United States*, 218 F. Supp. 677 .....12, 20, 21, 22
Smith Leasing Co. Inc. v. *Commissioner*, 43 T.C. No. 5 20, 21

Page

Trotz et al. v. *Commissioner*, 43 T.C. No. 13 .....20, 21
United States v. *Ludey*, 274 U.S. 295 9
Wyoming Builders, Inc. v. *United States*, 227 F. Supp. 534 .....12, 20, 21, 22

STATUTES, REGULATIONS AND RULINGS:

Depreciation Regulations on Income Taxes (1954 Code) T.D. 6182, 26 C.F.R. 1.167 (a) *et seq.*:

Sec. 1.167(a)-1(a) 9, 11
Sec. 1.167(a)-1(b) 10
Sec. 1.167(a)-1(c) 10, 11
Sec. 1.167(a)-8(a)(1) 12
Sec. 1.167(a)-10(b) 11
Sec. 1.167(b)-O-(a) 13

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 167 .....3, 6, 9, 10, 19
Sec. 1231 .....4, 9, 12, 19
Sec. 1245 .....8, 21
Sec. 1250 21

Rev. Rul. 62-92, (1962-1 Cum. Bull. 29) 21

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Petitioner, The Motorlease Corporation, prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the United States District Court for the District of Connecticut (R. 28a-53a) is reported at 215 F. Supp. 356.[1] The opinions of the court of

[1] "R. 1" to "R. 81" refers to pages of the original certified record in the United States District Court for the District of Connecticut which has been filed herein. "R. 1a" to "R. 85a" refers to pages of the certified reproduced portions of the transcript of the record and proceedings in the court below which has also been filed herein, including Appendix B to the brief of Appellant in the court below. In addition, for the convenience of the Court, we have filed nine additional copies of said Appendix B, which has the same pagination as in reproduced portions of the certified record of the court below, and will be referred to as "R. 1a" to "R. 55a".

appeals (Appendix A, *infra*, pp. 1a to 4a) are reported at 334 F. 2d 617.[2]

JURISDICTION

The judgment of the court of appeals (Appendix A, *infra*, p. 21a) was entered on July 15, 1964. A timely petition for rehearing (R. 64a-76a) was denied on August 20, 1964 (R. 79a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Petitioner is in the business of leasing motor vehicles to the public on long term leases, selling them at wholesale when they are returned from lease. In deducting a "reasonable allowance" for depreciation on the vehicles while used in the business, in accordance with the regulations issued by the Commissioner of Internal Revenue under section 167 of the Internal Revenue Code of 1954, petitioner, after making an estimate of the period of useful life of the vehicles in the business and of the salvage value of the vehicles as of the end of the period of estimated useful life, established a depreciation rate based on those estimates, which would return, as a depreciation deduction, the cost less the estimated salvage value during the period of estimated useful life. The Commissioner has conceded that petitioner's estimates were reasonable and that the resulting depreciation rate was reasonable. The question presented is whether, notwithstanding the reasonable-

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[2] Since the court below decided this case on the authority of, and for the reasons given in, *Fribourg Navigation Co.* v. *Commissioner*, 335 F. 2d 15, decided on the same day by an entirely different panel of the court below, we have also reprinted the opinions in the *Fribourg Navigation Co.* case in Appendix A, *infra*, pp. 5a to 21a.

ness of petitioner's estimates and the depreciation deductions based thereon and petitioner's compliance with the pertinent regulations, the Commissioner may nonetheless disallow all or part of the depreciation deduction otherwise allowable for the year-of-sale, in any instances where a vehicle is sold at a gain, the amount of the disallowance depending on the adjusted basis (book value) of the vehicle at the beginning of the year of sale.

STATUTE AND REGULATIONS INVOLVED

Section 167 of the Internal Revenue Code of 1954, 26 U.S.C. 167, and the pertinent provisions of the depreciation regulations issued thereunder are set forth in Appendix B, *infra,* pp. 22a to 28a.

STATEMENT

Petitioner Motorlease Corporation instituted this action in the United States District Court for the District of Connecticut to recover taxes paid in response to deficiencies assessed against it for the fiscal years ending September 30, 1957, 1958, 1959 and 1960 by reason of the disallowance of certain deductions for depreciation claimed by petitioner in those years (R. 6a-7a, 10a, 28a). The facts which give rise to the legal issue in the case are undisputed and may be summarized as follows:

Petitioner is a Connecticut corporation (R. 14a) engaged in the business of long-term leasing of motor vehicles to the public (R. 10a, 15a, 28a). During the years in question, petitioner deducted from income, on a straight line basis, a "reasonable allowance" for depreciation on the motor vehicles used in its business (R. 10a, 15a-18a, 21a, 28a). Petitioner never claimed any accelerated depreciation (R. 16a). In computing the depreciation allowance, petitioner meticulously fol-

lowed the requirements of the pertinent depreciation regulations adopted by the Commissioner of Internal Revenue under section 167 of the Internal Revenue Code of 1954, T.D. 6182, 26 C.F.R. sec. 1.167 (a) *et seq.* (R. 29a-30a). At the time of the acquisition of the vehicles, petitioner estimated the period of their useful life in its leasing business (R. 17a, 21a, 30a); it then estimated the salvage value of the vehicles as of the end of that period of useful life; and, basing its calculations on these estimates, petitioner established a depreciation rate which would return, as a reasonable depreciation deduction during the period of the estimated useful life, the cost less estimated salvage value (R. 30a; see R. 21a, 30a). When the leases were terminated and the vehicles were returned from lease, petitioner disposed of them either by trading them for new vehicles or by selling them at wholesale (R. 16a, 21a-25a). Of the vehicles disposed of by sale, many were sold at losses, that is to say, the selling price received for the vehicles was less than their book value (depreciated or adjusted basis) at the time of sale. In those instances where the selling price received for the vehicles exceeded their book value at the time of sale, the resulting gains were reported by petitioner at the capital gains rate in accordance with section 1231 of the Internal Revenue Code of 1954. (R. 28a, 21a-25a).[3]

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[3] During the year ending September 30, 1957, petitioner disposed of 133 vehicles by sale; 50 sales resulted in losses, and 83 resulted in gains (R. 21a-22a). During the year ending September 30, 1958, petitioner disposed of 317 vehicles by sale; 112 resulted in losses, and 205 resulted in gains (R. 22a-23a). During the year ending September 30, 1959, petitioner disposed of 353 vehicles by sale; 114 sales resulted in losses, and 239 resulted in gains (R. 23a). During the year ending September 30, 1960, petitioner disposed of 387 vehicles by sale; 129 sales resulted in losses, and 258 resulted in gains (R. 24a).

The Commissioner did not and does not challenge the depreciation plan adopted by petitioner. As stated by District Judge Blumenfeld (R. 47a): "In open court * * * the government admitted that the plaintiff's estimate of useful life was reasonable, that its estimate of salvage value was reasonable, and that its method of computing depreciation was proper. It does not make any claim that the method of depreciation used by taxpayer was improper or that there was any unreasonable, mistaken or improper use of any element in the method adopted by the taxpayer." Notwithstanding the fact, however, that petitioner, in adopting its depreciation allowance, had concededly complied with all the requirements of the applicable regulations, the Commissioner nonetheless disallowed depreciation deductions claimed during the year of sale with respect to all vehicles that were sold at a gain. (R. 10a, 28, R. 58a, Appendix A, *infra,* p. 2a). The basis for the Commissioner's disallowance was twofold. ***First,*** if the book value of a vehicle at the beginning of the year of sale was greater than its selling price, then any depreciation during the year of sale which would reduce the book value below the actual selling price was disallowed. This, of course, eliminated all capital gain arising out of the sale of such vehicle.[4] ***Second,*** if the book value of a vehicle at the beginning of the year of sale was less than the selling price, then all depreciation for such vehicle for the year of sale was disallowed, thereby limiting any gain to the difference

[4] For example, assume a book value (adjusted basis) for a vehicle at the beginning of the year of sale of $2,000.00, and claimed depreciation during that year of $400.00. If the vehicle were sold for $1700.00, and a $100.00 gain were reported, the Commissioner disallowed depreciation in the amount of $100.00, eliminating all gain.

between selling price and book value as of the beginning of the year of sale.[5] (R. 6a-7a, 10a, 58a, Appendix A, *infra,* p. 2a; see R. 40).

The application of this rigid formula to all sales where gains were reported resulted in the disallowance of depreciation deductions in some instances in such small amounts as $0.03, $2.82, $4.70 and $2.33 with respect to vehicles whose original costs were $2194.85 $2310.49, $2037.09 and $2803.17 respectively. (R. 27a, 38a).

After payment of the deficiencies based on the foregoing adjustments of depreciation deductions, and after rejections of the required claims for administrative refund, petitioner brought this action for refund in the United States District Court for the District of Connecticut claiming that the action of the Commissioner arbitrarily disregarded the provisions of section 167 of the Internal Revenue Code and the regulations thereunder (R. 15-20, R. 58a,. Appendix A, *infra,* pp. 2a-3a.) After hearing on cross-motions for summary judgment (R. 8a, 13a-27a), District Judge Blumenfeld granted petitioner's motion and entered judgment in its behalf (R. 54a-55a).

The District Court set forth its views in a lengthy opinion in which it analyzed in detail the pertinent regulations issued under section 167 of the Internal Revenue Code of 1954. (R. 28a-53a). It concluded that petitioner had fully complied with all require-

[5] For example, assume a book value (adjusted basis) for a vehicle at the beginning of the year of sale of $2,000.00 and claimed depreciation during that year of $50.00. If the vehicle were sold for $2,025.00, the Commissioner disallowed the entire claimed depreciation of $50.00, but a capital gain in the amount of $25.00 remained.

ments of the pertinent regulations and that the Commissioner's action in disallowing depreciation in the year of sale was not authorized or supported by any provision of those regulations. The decisions of this Court in *Massey Motors, Inc.* v. *United States* and *Commissioner* v. *Evans,* 364 U.S. 92, were carefully analyzed and were found to support petitioner's claims and bar the action of the Commissioner.

On appeal to the court below, the District Court's ruling was reversed (Appendix A, *infra,* pp. 1a-3a), Circuit Judge Waterman dissenting (Appendix A, *infra,* pp. 3a-4a) The reversal was "on the authority of, and for the reasons given in *Fribourg Navigation Co.* v. *Commissioner*" (Appendix A, *infra,* p. 2a) which was decided on the same day by an entirely different panel of the same court; with Circuit Judge Moore dissenting.[6]

The Commissioner's action in disallowing depreciation in the year of sale whenever a gain was reported[7] was sustained, in essence, on the theory that, no matter how reasonable the taxpayer's original estimate may have been, after an asset has been sold and its selling price established with certainty, it is not unreasonable to deny a taxpayer any depreciation deduction which would have the effect of either creating or increasing a capital gain, for the reason that the Internal Revenue Code and the regulations thereunder were not designed to encourage the "transmutation of ordinary income

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[6] We have been advised that a petition for a writ of certiorari is also being filed in the *Fribourg Navigation Co.* case.

[7] Hereafter, when reference is made to the disallowance of depreciation in the year of sale, we refer to either the partial or total disallowance, depending on the book value at beginning of the year of sale. See *supra,* p. 5, n. 4 and p. 6, n. 5.

into capital gains". (Appendix A, *infra,* p. 3a). The majority opinions in this case and in the *Fribourg Navigation Co.* case made no analysis of this Court's decisions in *Massey Motors* and *Evans,* nor was any reference even made to them.[8]

REASONS FOR GRANTING THE WRIT

We respectfully submit that this petition for a writ of certiorari should be granted for the following reasons: The simple formula approved by the court below requiring a routine and automatic disallowance of depreciation during the year of sale of an asset, whenever an asset is sold at a gain,—although it has a "beguiling appeal to it" (*Macabe Co., Inc., et al.* v. *Commissioner,* 42 T.C. No. 87, p. 8, September 29, 1964),[9]—is in violation of the pertinent provisions of the Internal Revenue Code of 1954 and the regulations promulgated thereunder by the Commissioner of Internal Revenue. The decision below is in conflict with the fundamental and basic principles concerning the nature and purposes of the depreciation allowance and of depreciation accounting enunciated by this Court in the *Massey Motors* and *Evans* cases, 364 U.S. 92, and the question presented remains one of substantial and continuing importance.

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[8] The District Court had found additional support for its position in the Congressional enactment in 1962 of legislation adding section 1245 to the Internal Revenue Code of 1954 (R. 48a-52a), a view not accepted by the court below (Appendix A, *infra,* pp. 10a-11a), but with which we concur. See also *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. No. 87, filed September 29, 1964, pp. 24-25.

[9] For the convenience of the Court, we are submitting herewith nine copies of the *Macabe Co.* opinion.

1. Section 167 of the Internal Revenue Code of 1954 (Appendix B, *infra,* p. 22a) permits a taxpayer to deduct from income a "reasonable allowance" as a "depreciation deduction" for the property used in the taxpayer's business. See *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98, 101; *United States* v. *Ludey,* 274 U.S. 295, 305.[10] The Commissioner has issued lengthy and detailed regulations setting forth how the "reasonable allowance" shall be determined by a taxpayer (T.D. 6182, 26 C.F.R. 1.167(a) *et seq.,* (Appendix B, *infra,* pp. 23a-28a),[11] and an examination of those regulations will disclose the clear conflict between those regulations and the decision of the court below.

The regulations define the depreciation allowance as the "amount which should be set aside for the taxable year in accordance with a reasonably consistent plan * * *, so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property." Section 1.167(a)-1(a). "Salvage value" is defined, not as the amount actually received upon the sale of an asset, but as "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business", and it is specifically provided that "salvage value shall not be changed at any time after the determination made at the time of acquisition

[10] Section 1231 of the Code provides that, upon the sale of such depreciable property, the excess of the selling price over the depreciated basis (book value) of the asset at the time of sale shall be treated, for tax purposes, on a capital gain basis, if the property was held for more than six months.

[11] Hereafter, we shall refer to the regulations only by their section numbers which are the same as in 26 C.F.R.

merely because of changes in price levels." Section 1.167(a)-1(c).[12] The regulations provide further that the "estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business." Section 1.167(a)-1(b).[13]

Accordingly, a taxpayer in adopting a depreciation plan for an asset, must first *estimate* the period of useful life of the asset in the business, must then *estimate* the salvage value as of the end of that period, and must then set up as a depreciation allowance the cost less the *estimated* salvage value spread over the *estimated* useful life of the asset. The regulations are not silent concerning when the depreciation allowance begins and when it ends, and it is specifically pro-

[12] It should be noted that the depreciation allowance is defined as the cost less the estimated salvage value, not as the cost less the actual selling or disposal price. This definition is sound because the allowance is a deduction to be taken currently during the use of an asset at a time when its disposal or selling price is unknown. The selling price, accordingly, is no part of the depreciation formula, other than as a measure of its reasonableness, and the definition in the regulations properly implements the statutory definition of depreciation in section 167 of the Internal Revenue Code which provides for a "reasonable allowance" rather than the specific amount of cost less actual selling or disposal price. There is no contention in this case that petitioner has claimed or is claiming more than cost less estimated salvage; what the Commissioner apparently contends is that, after disposal of an asset, his own definition of depreciation is no longer applicable.

[13] The District Court has referred to significant changes in the language of the regulations, adopted during the course of their consideration, which, in its view, emphasize the nature of the depreciation allowance as cost less estimated salvage value, rather than cost less actual disposal or selling price. See R. 31a-32a. See also *Macabe Company, Inc. et al.* v. *Commissioner*, 42 T.C. No. 87, p. 13.

vided that "The period for depreciation of an asset shall begin when an asset is placed in service and shall end when the asset is retired from service." Section 1.167(a)-10(b).[14] Nor are the regulations silent concerning the limitation below which depreciation may not go. They specifically provide that "an asset shall not be depreciated below a *reasonable salvage value* under any method of computing depreciation". Section 1-167(a)-1(a) (Italics added); see also Section 1-167(a)-1(c) ("in no event shall an asset (or an account) be depreciated below a reasonable salvage value.")[15] The limitation is *reasonable salvage value,* not actual selling price. See R. 29a, 31a; see also the opinion of Judge Waterman, dissenting below. Appendix A, *infra,* p. 4a; *Massey Motors Inc.* v. *United States,* 364 U.S. at 107; *Hertz Corp.* v. *United States,* 364 U.S. 122, 127 ("There is nothing inherent in the declining balance system which requires us to assume that depreciation should be allowed beyond what *reasonably appears to be the price that will be received* when the asset is retired") (Italics added)

It is plain, therefore, that the depreciation allowance is based on a system of *estimates* made at the time of acquisition of an asset, rather than on precise figures which become known only after its sale, and it is a necessary consequence of such a system that

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[14] The ruling of the court below, is, of course, in the teeth of the above provision. The court below would have depreciation end, not "when the asset is retired from service" as the regulations provide, but whenever, either at the beginning of or during the year of sale, the actual selling price had been reached.

[15] The ruling of the court below is, of course, also in the teeth of the above provision. The court below would have depreciation end not when "reasonable salvage value" has been reached, but when the actual selling price, known later, has been reached.

either the realization of some gains or the sustaining of some losses are normal events upon the disposition of depreciable assets and not merely rare and unforeseen possibilities.[16] Only in the rare case could the estimate of salvage value equal the actual selling price to the cent. The regulations, consistent with section 1231 of the Code, recognize this and specifically provide in section 1.167(a)-8(a)(1) for the capital gain treatment of any gain realized upon disposition of a depreciable asset after the "reasonable allowance" for depreciation had been taken. As the District Court aptly stated in this case (R. 39a), "The guide for the taxpayer, and the standard for the commissioner, is that of reasonableness. 'Reasonable allowance' is the theme for depreciation in the statute, and the regulations faithfully repeat it. See *Massey Motors Inc.* v. *United States, supra.*"[17]

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[16] "Of course, there is a risk of error in such projections, but prediction is the very essence of depreciation accounting." *Massey Motors, Inc.* v. *United States*, 364 U.S. at 105. See also *Wyoming Builders, Inc.* v. *United States*, 227 F. Supp. 534, 537. *S & A Co.* v. *United States*, 218 F. Supp. 677 (D. Minn.); see also *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 101 (the purpose of the depreciation allowance is to "*approximate and reflect* the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets") (Italics added.)

[17] The court below stated (Appendix A, *infra*, p. 3a): "Where it may be determined to an absolute certainty that such a profit will result from the allowance of further depreciation, as is the case here, there is no basis in reason or policy to permit the taxpayer to take advantage of what has proved to be an *inaccurate* estimate of salvage value." (Italics supplied). But herein lies the basic error of the court below. The question is not whether the estimate was accurate to the cent; the requirement is that it be reasonable. Further there is no "profit" that results to the taxpayer. It is the cost only that is being returned, and the question is what two elements add up to that cost—the depreciation plus estimated salvage value or depreciation plus actual selling price—, and, as to this, the regulations, as we have shown, are clear. See *supra*, pp. 9-12.

It is clear, we submit, that the foregoing regulations foreclose the Commissioner's rule, approved by the court below, of automatically disallowing a deduction for depreciation in the year in which an asset is sold for more than its adjusted basis.

The majority of the court in *Fribourg Navigation Co.* v. *Commissioner* (Appendix A, *infra*, pp. 9a-10a) purported to find support for the Commissioner's view in one sentence of one paragraph of the regulations which provides that "The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." Section 1.167(b)-O-(a). But reliance upon that one sentence is plainly misplaced. As the District Court properly noted with respect to this provision, "But, even here the test for allowable depreciation is still its reasonableness, * * * it does not automatically follow that a price received upon the sale of a depreciable automobile, somewhat greater than estimated, when it was acquired fourteen months before, established that the estimate and the depreciation based upon it was unreasonable" (R. 38a).[18] But more than that, that sentence is contained in a general section entitled, "Methods of computing depreciation—(a) in general", and relates to the reasonableness of a taxpayer's overall continuing depreciation plan. It follows immediately after a sentence dealing generally with recovery, by way of depreciation, of cost less estimated salvage over the "remaining useful life of the property", and, contained in the same paragraph,

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[18] See also *Macabe Company Inc., et al.* v. *Commissioner*, 42 T.C. No. 87, pp. 16-18, decided September 29, 1964 wherein the Tax Court stated that the Commissioner reads too much into the provision and that it does not provide the authority the Commissioner asserts, particularly in light of the other specific provisions of the regulations already referred to.

is the provision that claimed depreciation deductions "will be changed only where there is a clear and convincing basis for a change". Not one word is stated about actual selling price automatically requiring adjustments. This hardly seems to be a provision designed to require the disallowance of depreciation in the year of sale in every case where a gain is reported, however, small.[19]

2. The decision of the court below is in conflict with the principles enunciated by this Court in *Massey Motors, Inc.* v. *United States* and *Commissioner* v. *Robley H. Evans*, 364 U.S. 92. The specific question involved in those cases was whether the period of estimated useful life of an asset for depreciation purposes

[19] The rule adopted by the court below, presumably on the authority of *Cohn* v. *United States*, 259 F. 2d 371 (C.A. 6), limits the disallowance of depreciation to the year of sale only—a rule which the court below itself characterized as "perhaps logically inconsistent." Appendix A, *infra*, p. 7a. See the comments of Judge Moore dissenting in *Fribourg Navigation Co.*, Appendix A, *infra*, pp. 14a-15a). The effect of this rule could obviously be avoided merely by holding assets until a few days after the close of a tax year and then selling them. For example, in this case, every penny of disallowed depreciation could, under the rule adopted by the court below, have legitimately been retained by petitioner if the vehicles had been held until a few days into new tax years. Consequences such as this debase the depreciation concept, and a rule which so provides has a similar effect. Furthermore, the theory adopted by the court below invites abuse of the depreciation allowance. It eliminates arbitrarily all capital gain that might legitimately arise by reason of reasonable depreciation deductions during the year of sale, but at the same time, it permits the retention of a capital gain developed by excessive depreciation deductions in the years *prior* to the year of sale. This, of course, provides no incentive for reasonable estimates; on the contrary, it invites unreasonable estimates so as to increase early depreciation deductions, thereby reducing the basis of an asset below selling price *prior* to the year of sale and creating a gain which concededly may be retained. A more perverse reading of the statute and regulations is difficult to envisage.

was the period of estimated useful life in the business of the particular taxpayer, or the total period of physical or economic life of the asset. In concluding that useful life was the estimated period of use in the particular taxpayer's business, this Court pointed out that the primary purpose of depreciation accounting was "to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use * * * of the asset to the periods to which it contributes" *Id.* at 104. In order to accomplish this purpose, the Court stated, a taxpayer must "estimate the period the asset will be held in the business and the price that will be received for it on retirement. Of course, there is risk of error in such projections, but prediction is the very essence of depreciation accounting". *Id.* at 105.

This Court was fully aware that, upon sale of a depreciable asset, any gains "are capital gains and incur no more than a 25% tax rate" (*Id.* at 97), and it appreciated full well that its definition of useful life would not result in always eliminating a capital gain by equating estimated salvage value with selling price, as the Commissioner has done here. This Court's definition of useful life merely represented an approach which was "far more *likely to reflect* correctly the actual cost over the years in which the asset is employed in the business". *Id.* at 106. (Italics Supplied).[20] Indeed, in the *Evans* case, the Commissioner,

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[20] The Court concluded "that the Congress intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the *estimated* salvage, resale or second-hand value. This requires that the useful life of the asset be *related* to the period for which it may *reasonably* be expected to be employed in the taxpayer's business. Likewise salvage value must include *estimated* resale or second-hand value." *Id.* at 107. (Italics Supplied). See *supra*, p. 10, n. 12, and p. 12, n. 17.

in properly insisting that the taxpayer should have depreciated its vehicles on the basis of the period of estimated use in its business, with salvage value estimated as of that time, did not disallow depreciation in the year of sale, as such, nor did he attempt to equate estimated salvage value with actual sales price in order to eliminate a capital gain. The Commissioner, himself, in revising the taxpayer's claimed depreciation deductions, made the very estimates that the taxpayer should have made in the first place. Knowing that the vehicles had already been sold for $1380.00, he *estimated* reasonable salvage value at $1325.00 and allowed depreciation down to that figure, thereby permitting a capital gain in the amount of $55.00 per car, all of which resulted from depreciation deductions during the year of sale down to a reasonably estimated salvage value, but below an already known selling price. These facts are specifically alluded to in this Court's opinion. 364 U.S. at 94-95.[21] What the Commissioner did in *Evans,* and what was approved by this Court in that case as the proper method of computing the "reasonable allowance" for depreciation, is precisely what petitioner has done here and what the court below has disapproved.

In the Government's brief to this Court in the *Evans* case, the Commissioner argued, and properly we think, that the depreciation allowance was not intended to be a device to convert ordinary income into capital gains. In arguing that such an improper conversion of ordi-

[21] As District Judge Blumenfeld pointed out (R. 37a): "Indeed, it is clear that the commissioner did not even argue in *Massey* for the proposal he asserts here. In calculating the taxpayer's deficiencies, he used an estimated salvage value of $1325.00 per car, rather than $1380.00, which was the actual selling price. He was not trying to eliminate all interplay between § 167 and § 1231."

nary income into capital gains would not result from the adoption of his definitions of "useful life" and "salvage value", even though capital gains would often be involved (see Brief for the Commissioner in this Court in the *Evans* case, No. 143, Oct. Term, 1959, pp. 10-11, 16-17), the Commissioner pointed out (Id at p. 29):

> On the other hand, if, as the Commissioner contends, the depreciation deduction must be based upon a rate determined by the period during which the asset can reasonably be expected to be used in the taxpayer's business and a reasonable estimate of salvage value at the end of that period, there will be no conversion of ordinary income into capital gains. *Ordinary and predictable salvage value, determined as of the time that sale of the asset is contemplated, will impose a realistic ceiling upon depreciation claims.*" (Italics added)

Throughout the Commissioner's briefs in *Massey* and *Evans* there was not one single reference to any principle of disallowing depreciation in the year of sale whenever a gain was reported. The decision in *Cohn* v. *United States*, 259 F. 2d 371 (C.A. 6), which apparently is relied on for the principle (R. 39a *et seq*), had been decided long before the Government's briefs were filed in *Massey* and *Evans*, and yet no reference was made to the *Cohn* case as authority for any such proposition.[22]

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[22] In the companion case, *Hertz Corp.* v. *United States*, 364 U.S. 122, the Government's Brief (No. 283, Oct. Term, 1959, pp. 32, n. 6 and 40) quotes from *Cohn* (259 F. 2d at 377) only for the general proposition that salvage value must be estimated and taken into consideration, and on page 50, n. 27 it describes the holding as follows: "Taxpayers in that case had not deducted any salvage value in the first instance (though they were operating under the straight line method) *and the court appropriately held that no*

It is clear that what was approved by this Court in the *Massey* and *Evans* cases as the proper method of computing the "reasonable allowance" for depreciation is precisely what the court below has disapproved,—and without even a reference to this Court's opinion.[23]

Our view of this Court's decision in *Massey Motors* and *Evans* is sustained by the recent decision of the Tax Court in *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. No. 87, filed September 29, 1964. There the Tax Court, in an opinion reviewed by the court, set aside the Commissioner's disallowance of depreciation deductions during the year of sale with respect to an office building whose book value at the beginning of the year of sale was less than the price for which it was sold. The Commissioner's disallowance was based on the contention, made here also, that "if a depreciation deduction were allowed in the year of sale when the sales price equals or exceeds a taxpayer's undepreciated basis as of the beginning of said year, the taxpayer would, in effect, be recovering, tax free, more than the cost to him of the asset" (pp. 7-8). The Tax Court noted that the Commissioner's contention "has, because of its simplicity, a beguiling appeal to it", but

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further depreciation deductions were allowable after the assets had been depreciated down to reasonable salvage value." (Italics added). This, of course, is a far cry from any proposition requiring an automatic disallowance of depreciation in the year of sale geared to selling price as contrasted with "reasonable salvage value".

[23] Circuit Judge Moore, in his dissenting opinion in the *Fribourg Navigation Co.* case stated (Appendix A, *infra,* p. 17a): *"Motorlease* as decided by this court (the court below) in substance and actuality goes contrary to the decisions of the Supreme Court in *Massey* and *Evans.* * * * *Motorlease* was analogous to, and should have been controlled by, *Massey, Evans* and *Hertz.* Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein."

concluded that "a closer scrutiny of respondent's (Commissioner's) argument convinces us that it is incorrect * * *" (p. 8). After reviewing the provisions of sections 167 and 1231 of the Internal Revenue Code and the Commissioner's regulations under section 167, and after analyzing the opinion of this Court in *Massey Motors* and *Evans* in detail, the Court held that the Commissioner "has failed to comply with the underlying intent of section 167 and the specific provisions of his own regulations thereunder" (p. 8). In essence, the Tax Court held that if the required estimates of useful life and salvage value were reasonably made, then there can be no automatic disallowance of depreciation in the year of sale simply because the actual selling or disposal price may have exceeded the estimated salvage value. The Court specifically stated that it disagreed with the rationale of the court below in both *Motorlease* and *Fribourg Navigation Co.*, even though its own decision in *Fribourg Navigation Co.*, had been affirmed by the court below.[24] It seems quite

[24] The Tax Court stated, however, that it agreed with the *results* in those cases. With respect to *Motorlease*, Judge Fay wrote (p. 11a, n. 10): "There is no indication in that case that the excess of sales price received over the estimate of salvage value resulted from an increase in market values. In fact, the opinion of the Circuit Court therein suggests that this excess resulted from an inaccurate estimate." Apparently, Judge Fay looked no further than the majority opinion of the court below, for the record in *Motorlease* and the District Court's opinion show clearly that the estimates in *Motorlease* were reasonable and were conceded to be so (R. 30a, 47a). Since, however, under the view of the majority of the court below, the reasonableness of estimates was not deemed to be a controlling factor, it is apparent that when Chief Judge Lumbard referred to "an inaccurate estimate" of salvage value (Appendix A, *infra*, p. 3a), he referred to any instance where selling price exceeded the estimate of salvage value. But Judge Fay's opinion rejects that view, and his concurrence in the result in *Motorlease* is based on an apparent misunderstanding of the facts. The Tax Court's opinion in *Macabe* is plainly in conflict with the decision below.

clear that the Tax Court has now abandoned and rejected the view earlier expressed in its own *Fribourg Navigation Co.* decision even though it was affirmed by the court below in the decision which was the basis for the decision in this case.[25] The Tax Court's strong reliance on the opinion of this Court in *Massey Motors* and *Evans* in reaching its present conclusions in *Macabe* emphasizes the conflict between the decisions below and this Court's opinion in *Massey Motors* and *Evans*. See also *S & A Company* v. *United States*, 218 F. Supp. 677 (D. Minn. 1963); *Kimball Gas Products Co.* v. *United States*, 63-2 U.S.T.C. par. 9507 (W.D. Tex. 1962); *Wyoming Builders, Inc.* v. *United States*, 227 F. Supp. 534 (D. Wyo. 1964); cf. *Killebrew* v. *United States*, 14 AFTR 2d 5565 (E.D. Tenn. 1964).

3. Finally, the question presented in this case is of substantial importance in the administration of the tax laws, not only to taxpayers, but also to the Internal Revenue Service. The question whether depreciation can or must be disallowed in the year when an asset is sold at a gain arises not out of unusual or rare circumstances, but, indeed, can be involved in practically every sale of real or personal depreciable property used in business. The question has not been limited to cases involving the sale of leased vehicles, as in this case, or

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[25] Since its decision in *Macabe*, the Tax Court, on the authority of *Macabe*, has set aside the Commissioner's disallowance of depreciation deductions during the year of sale in the following cases: *C. L. Nichols et al* v. *Commissioner*, 43 T.C. No. 13, filed November 6, 1964. *Harry Trotz et al* v. *Commissioner*, 43 T.C. No. 14, filed November 6, 1964; *Moses Lake Homes, Inc.* v. *Commissioner*, T.C. Memo. 1964-289, filed November 5, 1964; *Palmaneda Adams* v. *Commissioner*, T.C. Memo. 1964-286, filed October 30, 1964. And see *Smith Leasing Co. Inc.* v. *Commissioner*, 43 T.C. No. 5, October 20, 1964, in which the *Macabe* decision was distinguished on the facts.

vessels, as in the *Fribourg Navigation Co.* case. It has been and is currently involved in cases dealing with the sale of all variety of depreciable property, both real and personal. See *e.g., S & A Company* v. *United States, supra; Kimball Gas Products Co.* v. *United States, supra; Wyoming Builders, Inc.,* v. *United States, supra; Macabe Company, Inc.* v. *Commissioner, supra; Killebrew* v. *United States, supra,* and cases cited in footnote 25, *supra,* p. 20.

In 1962, long after the Commissioner acted in this case and many months after the complaint was filed herein by petitioner, the Commissioner issued Rev. Rul. 62-92 (1962-1 Cum. Bull, 29) adopting the position asserted herein as Service policy in all cases involving the sale at a gain of all depreciable assets used in the trade or business. We are unable to estimate the number of cases dealing with this question that are now pending in the federal district courts and in the Tax Court or the number of cases that are either pending or being developed within the Internal Revenue Service. Petitioner has been informed by the American Automotive Leasing Association, of which it is a member, that, of the seventy company members of that Association, at least thirty companies already have cases pending within the Service for open tax years which involve the issue in this case. The number of cases will undoubtedly increase substantially when further audits for open years are completed, particularly in view of the adoption of Rev. Rul. 62-92.[26] It should

[26] The scope of Rev. Rul. 62-92 will undoubtedly be narrowed for the future because of the additions to the Internal Revenue Code of section 1245 in 1962 and section 1250 in 1964. Section 1245 removes the capital gains treatment with respect to personal property and certain real property sold during a taxable year after December 31, 1962 to the extent of depreciation taken after

be pointed out that the foregoing figures are only for those long-term vehicle leasing companies who are Association members. They do not include non-member vehicle leasing companies; nor do they include daily rental companies or truck leasing companies or equipment leasing companies. Moreover, since the question herein may be pending in any case involving the sale at a gain of any real or personal depreciable property used in business, the number of pending cases is in all probability extremely large, and the amount of taxes involved must necessarily be—conservatively speaking—extremely substantial, involving untold millions of dollars.

Cases presenting this issue are now pending on appeal in other Circuits. The *S & A* case, *supra,* is pending on appeal to the Eighth Circuit; the *Kimball Gas Co.* case, *supra,* is pending on appeal to the Fifth Circuit; and the *Wyoming Builders* case, *supra,* is pending on appeal to the Tenth Circuit. All of these decisions were decided against the Commissioner and in favor of the taxpayers in the District Courts. But see *Killebrew* v. *United States, supra.* The recent Tax

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December 31, 1961. Section 1250 removes the capital gains treatment with respect to real estate (not subject to section 1245) sold after December 31, 1963 to the extent of depreciation taken after December 31, 1963 if the property was held for one year or less, or to extent of the excess of such depreciation over straight line depreciation if the property was held for more than a year, but not more than 20 months. If the real property was held for more than 20 months, the amount treated as ordinary income is reduced by one percent for each full month over 20 that the property was held.

But even with these additions to the Internal Revenue Code, the question is still very much involved for the future with respect to the sale of real estate held for more than one year on which straight line depreciation had been taken. It is also involved to a more limited extent even where accelerated depreciation had been taken and the real proprty was held more than 20 months.

Court decision in the *Macabe* case, *supra,* will, if appealed by the Government, go to the Ninth Circuit, and, in any event, will undoubtedly be followed by other Tax Court decisions to be appealed to other Circuits. See *e.g.,* the cases cited in footnote 25, *supra,* p. 20.

We respectfully submit that it is important to the administration of the tax laws that the specific issue herein be definitively settled by this Court at this time. It is apparent from the cases to which we have referred that, in spite of what we believe was a clear and lucid enunciation of guiding principles by this Court in *Massey Motors and Evans,* there is, nevertheless, at the present time, a confusion of decision and a conflict of understanding that should be resolved. Both cases below had vigorous dissenting opinions; the Tax Court has apparently changed its mind; and the District Courts reach different results. This situation breeds litigation unnecessarily, casting an undue and unreasonable burden not only on the courts, but also on the litigants, both Government and private.

CONCLUSION

For the foregoing reasons, therefore, it is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

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APPENDIX A

UNITED STATES OF AMERICA, *Appellant,*

v.

THE MOTORLEASE CORPORATION, *Appellee.*

No. 232, Docket 28470.

United States Court of Appeals
Second Circuit.

Argued Jan. 28, 1964.

Decided July 15, 1964.

* * * * * * * * * *

Before LUMBARD, Chief Judge, and WATERMAN and MARSHALL, Circuit Judges.

LUMBARD, Chief Judge:

[1] The question presented is whether a taxpayer may take a depreciation deduction for the year of sale of a depreciable asset in excess of the amount by which the adjusted basis of the asset at the beginning of the year of sale exceeds the amount realized upon the sale. In other words, may a taxpayer, for example, claim depreciation in excess of $250 when the adjusted basis of the asset at the beginning of the taxable year is $1000 and the asset is sold during the taxable year for $750 at a time when its adjusted basis is $400 in accordance with an already established scale of straight-line depreciation. We hold that in such a case the deduction would be limited to $250.

The Motorlease Corporation, the taxpayer, is a Connecticut corporation engaged in leasing automobiles. After employing them in the leasing operation for a period of from one to two years, Motorlease generally disposes of the automobiles either by sale or trade-in on new auto-

mobiles. In three of the years here relevant more than 300 automobiles were disposed of by sale.

Motorlease depreciated the automobiles on a straight-line basis, establishing a depreciation schedule of 2½ percent per month which incorporated an estimate of the useful life of the vehicles in the leasing operation and an estimate of their probable salvage value at the termination of that useful life.

The automobile sales here relevant were of two types: first, where the sale price exceeded the adjusted basis—cost less depreciation already taken—of the automobile at the beginning of the taxable year; and second, where the sale price, though less than the adjusted basis at the beginning of the taxable year, exceeded the adjusted basis of the automobile at the date of sale as computed pro rata according to the established depreciation schedule.

In the taxable years ending September 30, 1957 through September 30, 1960, the taxpayer claimed depreciation deductions for these automobiles in the full amount allowable under its established depreciation schedule, disregarding the amounts received upon sale. The Commissioner of Internal Revenue disallowed as depreciation deductions the amounts in excess of the amount by which the adjusted basis of the automobile at the beginning of the year of sale exceeded the sale price. After payment of the defficiencies, and upon rejection of the required administrative claims for refund, the taxpayer brought suit for refund in the District of Connecticut. On cross motions for summary judgment, Judge Blumenfeld granted the taxpayer's motion. 215 F. Supp. 356 (D. Conn. 1963). On the authority of, and for the reasons given in Fribourg Navigation Co. v. Commissioner, 2 Cir., — F. 2d —, decided today, we reverse the judgment of the district court and direct that sumary judgment be entered in favor of the Commissioner.

[2] The taxpayer here relies upon essentially the same Code sections and regulations as were relied upon by the

taxpayer in Fribourg. But neither the Code nor the regulations are dispositive of the issue. The question rather is which construction of these sections best comports with the congressional design in establishing the depreciation provisions of the Internal Revenue Laws. The transmutation of ordinary income into capital gains is one consequence which these provisions certainly were not designed to encourage. Their design is to prevent a loss to the taxpayer through the unrecovered cost of depreciable assets, not to provide the taxpayer with a profit over and above that cost. Where it may be determined to an absolute certainty that such a profit will result from the allowance of further depreciation, as is the case here, there is no basis in reason or policy to permit the taxpayer to take advantage of what has proved to be an inaccurate estimate of salvage value.

[3] The taxpayer emphasizes the apparent inconsistency in the Commissioner's disallowance, on the one hand, of the depreciation deductions here involved and his refusal, on the other hand, to allow additional depreciation deductions in the case of assets sold below their adjusted basis. The government maintains that this difficulty is obviated by § 1231 of the 1954 Code, but inasmuch as § 1231 applies only to net transactions this remedy is only partial. Whatever may be the merits of the taxpayer's contention, inasmuch as the taxpayer failed to raise this claim in the district court we cannot consider it on this appeal.

The judgment of the district court is reversed. We direct that summary judgment be entered in favor of the government.

WATERMAN, Circuit Judge (dissenting):

I would affirm the district court on the opinion below, 215 F. Supp. 356 (1963) and I therefore respectfully dissent from the order of my brothers directing that court to enter summary judgment in favor of the government.

In a case involving the liability of a taxpayer to pay an income tax it seems a rather strange doctrine that neither the Code nor the regulations are dispositive of the issue of the extent or character of that liability. The court below, in its most careful exposition, first set forth the pertinent statute, 26 U.S.C. § 167(a) authorizing the depreciation deduction, "including a reasonable allowance for obsolescence," then the regulation § 1.167(a)-1 stating how this allowance is permitted to be set aside during the useful life of the asset being depreciated provided the asset is not depreciated below a reasonable salvage value, and then the regulation § 1.167(a)-1(c) defining "salvage value." After quoting these the judge then held, as it seems obvious to me in view of the government's concessions[1] he was required to hold, that the language of the Code and the regulations permitted this good-faith taxpayer to do precisely what it did do.

I am heartened by the fact that Judge Moore in his dissenting opinion in Fribourg Navigation Co. v. Commissioner, decided this day, joins me in questioning the result my brothers have reached here, and I adopt his reasoning in that case to the extent that his well-considered analysis of the issue in Fribourg is applicable to Motorlease.

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[1] There was no issue of a taxpayer's fraud or evasion in this case—simply an issue of how an income tax statute and the regulations of the Commissioner pursuant to that statute should be read.

The court below, 215 F.Supp. at 365, makes this very clear:

"In open court, at the time of the hearing on these motions, the government admitted that the plaintiff's estimate of useful life was reasonable, that its estimate of salvage value was reasonable, and that its method of computing its depreciation was proper. It does not make any claim that the method of depreciation used by the taxpayer was improper or that there was any unreasonable mistaken or improper use of any element in the method adopted by the taxpayer."

FRIBOURG NAVIGATION COMPANY, INC., *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

No. 72, Docket 28165.

United States Court of Appeals
Second Circuit.

Argued Jan. 16, 1964.

Decided July 15, 1964.

* * * * * * * * * * *

Before SWAN, MOORE and SMITH, Circuit Judges.

J. JOSEPH SMITH, Circuit Judge.

[1] The sole issue presented by this appeal is whether a taxpayer is entitled to a depreciation deduction for the year in which a depreciable asset is sold at more than its depreciated cost. The Tax Court sustained the Commissioner's disallowance of the deduction, and the taxpayer has appealed to this court. We agree with the Tax Court's determination and affirm the judgment.

The taxpayer, Fribourg Navigation Co., operated two cargo ships in foreign commerce. One of these was the S. S. Feuer, a Liberty ship purchased in December of 1955 for $469,000. Just prior to purchasing the Feuer, the taxpayer secured a letter ruling from the engineering and Valuation Branch of the Internal Revenue Service advising that it would accept straight line depreciation of the ship over a useful economic life of three years, subject to change if warranted by subsequent experience. The letter ruling also advised that the Internal Revenue Service would accept a salvage value of $54,000 on the Feuer. This estimate of the Feuer's useful economic life and salvage value, concededly reasonable in December of 1955, was thrown out of kilter by a scarcity of ships resulting from the Suez Crisis of 1956-57, which sharply inflated the values of

ships normally considered obsolete. In June of 1957 the taxpayer accepted an offer to sell the Feuer for $700,000, $231,000 more than it had paid for the ship a year and a half before. When the Feuer was delivered to its new owner on December 23, 1957, the contract terms were slightly modified, reducing the purchase price to $695,500.

Relying on the letter ruling, the taxpayer deducted the $54,000 estimated salvage value from the $469,000 cost and spread the $415,000 equally over a three year useful life—from December 21, 1955 to December 21, 1958. This resulted in a daily depreciation of about $378.65. On its income tax returns, the taxpayer claimed the following depreciation deductions for the Feuer:

Calendar Year	Period of Ownership	Depreciation
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24
	Total	$277,739.51

On March 7, 1957, prior to the sale of the Feuer, the taxpayer adopted a plan of complete liquidation, which was carried out within 12 months. Since the liquidation came within the sanctuary of Section 337 of the Internal Revenue Code, the taxpayer incurred no tax liability on the capital gain from the sale of the Feuer. For information purposes only, the taxpayer reported a captial gain of $504,239.51 (the difference between the selling price and the adjusted basis after taking a depreciation allowance for 357½ days of 1957). The taxpayer reported a gross income (after cost of operations) of $391,811.31 in 1957. This was reduced to $141,193.35 after deductions of $250,617.96, including $135,367.24 for the depreciation of the Feuer in 1957.

The Commissioner disallowed the $135,367.24 deduction in full, taking the position that a taxpayer cannot depre-

ciate an asset during the year its sale reveals that it has not depreciated. At the start of 1957 the Feuer had an adjusted basis of $326,627.73. In December of 1957 it was sold for $695,500. The Commissioner claims Congress never intended to permit further depreciation under such circumstances, and that a depreciation deduction claimed when the taxpayer knows with certainty that the asset has appreciated rather than depreciated must be disallowed as unreasonable. The Commissioner does not seek to recapture the depreciation deductions allowed for 1955 and 1956. He is content with contending only that depreciation disallowance should be limited to the year in which an asset is sold for more than its adjusted basis.

Though perhaps logically inconsistent, this position is strongly suggested by the opinion of the Sixth Circuit in Cohn v. United States, 259 F. 2d 371 (1958), which first permitted the Commissioner to disallow depreciation deductions on assets sold for more than their adjusted basis. In 1941-42 the taxpayers in Cohn began to operate three flying schools to train pilots under the Army Air Corps Contract Flying School Program. The taxpayers determined that their contracts for operation of the schools would terminate at the end of 1944, and the equipment they had purchased to operate the schools should be depreciated over a useful economic life ending on December 31, 1944. In computing their depreciation deductions, the taxpayers neglected to place any salvage value on the equipment, though operators of similar flying schools used an estimated salvage value of ten percent in establishing their depreciation schedules. One of the schools ceased its operations on August 4. 1944, and its equipment was sold at auction during that month. The property of the other two schools was auctioned off in November of 1944. Because of wartime shortages, the equipment brought substantial sums, exceeding the adjusted basis of the assets at the beginning of 1944. The Commissioner disallowed the depreciation deductions for all the years as excessive and

unreasonable. The District Court found that a salvage value of 10% of the original cost should have been used in computing the depreciation schedules and that the actual sales price should have been substituted for the salvage value in the year in which the asset was sold. Only the latter holding was appealed to the Sixth Circuit, which affirmed the District Court.

The holding of Cohn has been variously construed. Some have taken a very narrow view, reading Cohn as holding only that on the peculiar facts the District Court's finding that the salvage value should be redetermined in the year of the assets' sale to reflect the sales price was not clearly erroneous. Others have considered it to lay down a rule of law that the depreciation deduction for the year in which an asset is sold must be adjusted to limit the deduction to the amount, if any, by which the adjusted basis at the start of the year exceeds the sales price. Compare Motorlease Corp. v. United States, 215 F. Supp. 356, 361-64 (D.C. Conn. 1963) (rev'd on appeal, 2 Cir., 334 F. 2d 617, 1964) and Note, 41 Ore. L. Rev. 159, 165-66 (1962) with Randolph D. Rouse, 39 T.C. 70 (1962); Rev. Rul. 62-92, 1962-1 C.B. 29; and Note, 37 Tex. L. Rev. 787 (1959).

Though it could have been more explicit, we think that the Cohn case adequately supports the Commissioner's position and supports affirmance of the Tax Court's decision in this case. Sectoin 167(a) of the Internal Revenue Code states as a general rule: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) * * * of property used in the trade or business * * *." Thus the dispute centers about whether it is reasonable to allow a deduction for depreciation in the year in which an asset is sold for more than its adjusted basis. We think such allowance unreasonable, for it contravenes the basic purpose of the depreciation deduction.

[2] Basically, our income tax is a tax on net income, and the expenses of generating income are normally considered deductible from gross income. The purpose of the depreciation allowance is to enable the taxpayer to recover the net cost of a wasting asset used in his trade or business by charging the diminution in the asset's value each year against the gross income of that year. Because our income tax system is based on annual reporting and liability and the taxpayer normally holds wasting assets for more than a year, the proper amount of depreciation to be taken each year must depend on estimates. The proper depreciation allowance "is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the property, equal the cost * * *" Treasury Regulations, § 1.167(a)-1. See also United States v. Ludey, 274 U.S. 295, 300-301, 47 S. Ct. 608, 71 L. Ed. 1054 (1927).

The Commissioner does not claim that the depreciation schedule adopted by the taxpayer in 1955 when the Feuer was purchased was unreasonable. Rather his claim is that it is unreasonable to follow an estimate when one knows that estimate is incorrect. The Commissioner's position finds support in § 1.167(b)-0 (a) of the Regulations in force during 1957:

> "Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost of other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be

> determined upon the basis of conditions known to exist at the end of the period for which the return is made."

We think the Regulations make it plain that the relevant time for assessing the reasonableness of the depreciation deduction is the end of the period for which the return is made. At then end of 1957 it hardly seems reasonable to claim that the value of the Feuer had declined below its adjusted basis.

To be sure, the Regualtions also provide that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value." § 1.167(a)-1. If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on acounting methods. But no such practical difficulty presents itself here. All that is required is a comparsion of the asset's selling price with its adjusted basis. A sale which indicates that an estimated decline in an asset's value is greatly out of line is not a "mere fluctuation in market value," but "a single and final adjustment in the closing of the books on the books on the asset involved." Cohn v. United States, supra, 259 F. 2d at 378.

Though the increment in the Feuer's value resulted from a fortuity normally associated with capital gain, the depreciation allowance is measured by the net cost of the asset to the taxpayer. * If an asset costs a taxpayer nothing for a year, the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance. Here the sale established with mathmatical certainty that the entire cost of the ship had been recovered by the sale. No injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it.

[3] Little support for the taxpayer's position can be derived from Congressional passage in 1962 of § 1962 of

§ 1245 of the Internal Revenue Code. Section 1245 is addressed to a much broader problem than disallowance of depreciation deductions for the year of an asset's sale. The Cohn case refused to permit the Commissioner to recapture depreciation in years other than that of an asset's sale. Section 1245 permits recapture of depreciation allowed in years prior to an asset's sale by treating gain on the transfer of certain specified property to the extent of depreciation taken after 1961 as ordinary income instead of caiptal gains. See generally, Schapiro, Recapture of Depreciation and Section 1245 of the Internal Revenue Code, 72 Yale L.J. 1483 (1963).

The judgment of the Tax Court is affirmed.

MOORE, Circuit Judge (dissenting).

By its decision in this case and in United States v. The Motorlease Corporation, 2 Cir., 334 F.2d 617, this court not only enacts judicial legislation which the Congress itself has rejected but overturns judicial and administrative precedents of many years' standing in the field of allowable depreciation.

The law in effect in 1957, the applicable year here, provided as to "DEPRECIATION" that "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in a trade or business, or (2) of property held for the production of income." (Sec. 167, Int.Rev. Code of 1954.) The basis, "for the purpose of determining the gain on the sale or other disposition of such property," was to be the "adjusted basis provided in section 1011." Sec. 167(f).

The Regulations provide for the setting aside as a depreciation deduction an amount "in accordance with a reasonably consistent plan," "so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the depreciable property, equal the cost or other basis

of the property as provided in section 167(f) and § 1.167(f)-1."

"Useful life," here determined by the Commissioner to have been three years, was subject to modification "by reason of conditions known to exist at the end of the taxable year" and could be "redetermined" but "only when the change in the useful life is significant." §1.167 (b).

The other important factor, "salvage value," is defined with clarity as "the amount (determined at the time of acquisition) which is estimated will be realized upon sale or other disposition—" §1.167(c)-1. The Regulation contains the injunctions that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels," and that "Salvage value must be taken into account in determining the depreciation deduction * * *" The time period during which depreciation is allowable is from the time "when the asset is placed in service" until it "is retired from service." Proportionate parts of one year's depreciation are allowable for the first and last years during which the asset is in service. § 1.167(g)-10.

These underlying and controlling legal principles are clear. Their application to the facts of this case are (or should be) equally clear.

The asset or property is the S. S. Feuer. Its acquisition date was December 21, 1955—the price $469,000.

The Commissioner accepted "Useful life" as three years and salvage value as $54,000. The "reasonably consistent plan" required the setting aside of $378.65 a day for depreciation. If this were done, the "aggregate of the amounts set aside" ($415,000) "plus the salvage value" ($54,000) would equal the cost ($469,000).

During 1957 the S. S. Feuer earned some $289,340 as gross profit. To achieve this profit the Feuer had to be

used and after each day of its use it had suffered wear and tear (depreciation) to the extent of $378.65. The $289,340 was not the net income on which the petitioner under the law was required to pay taxes. Its obligation rested upon net income and net income was obtained only after depreciation ($135,367.24) was deducted. Thus far there can be no variance in thought or legal result—even by the Commissioner, the Tax Court or the majority.

But just as our much vaunted system of law on a national basis can be so easily ignored and repudiated both by judicial and extra-judicial fiats, even more so is this true on an international basis. International law and contract to the contrary, the Suez Canal was closed to shipping in the latter part of 1956. Suddenly the price of ships soared, petitioner chose to forego the balance (approximately one and a half years—or one-half of the agreed-upon useful life) of the contemplated three-year reasonable plan period and sold the Feuer in June 1957 for $700,000 (actually $695,500 on closing).

The tax computation should have been simple. The cost ($469,000) less depreciation to the date of sale ($277,739.51) enabled petitioner because of its sale for $695.500 to obtain a capital gain of $504,239.51, which petitioner reported.

Particularly important is it to note that although the Suez crisis had radically affected the shipping situation and ship values, the Commissioner did not avail himself of the remedy of modification of useful life and after such redetermination then, but only then, of a redetermination of salvage value. Actually his own regulation prevented him from changing salvage value "merely because of changes in price levels."

Faced with this insurmountable barrier of Congressional enactment, precedent, and regulation, the Commissioner resolved the problem by the simple and much-used device of amending the statutes without the aid or even partici-

pation of Congress. To the depreciation allowance section he merely added in substance the words "except in the event that the asset shall be sold prior to the expiration of its useful life, in which event no depreciation shall be allowed for the year in which such sale is made if the price realized exceeds the depreciated cost at the beginning of such taxable year."

There would have been nothing wrong with such a statute; in fact, the Treasury had been trying to have similar provisions enacted for years. If, however, under our three branches of government system, the legislative branch does not function to the satisfaction of the executive and judicial branches, it is apparently incumbent on the latter two to take over the legislative powers. To be sure the taxpayer had planned his business transaction relying on the law as it was on the books at the time but sooner or later taxpayers must learn not to rely upon Commissioner's rulings, acquiescences, prior audits—or even Commissioners and courts.

What possible rationale is available for the result reached by the majority? They first infer that the Commissioner is being quite magnanimous in being "content" with only a 1957 disallowance as if taxes and the law were to depend on Commissioners' whims, caprices and contentment. They recognize that in so doing that the Commissioner was "perhaps logically inconsistent" as indeed he was. In enacting his own *ex post facto* legislation, he might just as well have had a sale for more than cost eliminate all depreciation for three years or even from the date of acquisition.

To arrive at its result the majority relies exclusively on what it can only call a strong suggestion in Cohn v. United States, 259 F.2d 371 (6th Cir. 1958). It ignores (as it must) the many Supreme Court decisions and the statutes and regulations leading to a contrary result. When the Cohn case is read, no principle is found therein which could support the Commissioner's ruling. The taxpayers

in Cohn had not fixed any salvage value for their property at the end of its useful life. For this value the District Court chose the sale price. There was no holding in Cohn that sale price during the course of useful life (here at the half-way point) should eliminate all depreciation in the year of sale. Nor can Cohn possibly be stretched to stand for the proposition that any "reasonably consistent plan" adopted by a taxpayer is to be considered as abrogated by a sale. Any such conclusion would be in specific disregard of the statutes and regulations which provide for the methods of redetermination of useful life and salvage value.

In Randolph D. Rouse, 39 T.C. 70 (1962) (the Tax Court here held it "necessary to recognize the Rouse case as dispositive of the question presented in this case") relied upon Cohn. Depreciation was disallowed only as to the houses which Rouse had sold. Since he had not adopted any "reasonably consistent plan" or estimated any salvage value at the time of acquisition a situation somewhat similar to that in Cohn existed. Neither set of facts leads to a result which should be controlling or even persuasive here.

The Tax Court assumed, erroneously and without any supporting basis in my opinion, that "changes in economic conditions have brought about new considerations by the courts of the old, well-established rules relating to depreciation allowances in the light of the rising market prices of used assets and the corresponding realization of large gains upon the resale of such used assets." Massey Motors, v. United States, 364 U.S. 92, 80 S.Ct. 1411, 4 L.Ed.2d 1592 (1960) and Hertz v. United States, 364 U.S. 122, 80 S.Ct. 1420, 4 L.Ed.2d 1603 (1960) are cited as examples for this proposition. Actually neither case justifies any such conclusion. Both cases involved taxpayers whose business experience enabled them to determine an estimated salvage value based upon sales long before the end of the physical life of the automobiles used in their businesses. Instead of declaring the principle that sale automatically disqualified

a taxpayer from claiming depreciation if the sale price was higher than the depreciated value at the beginning of the year, the Massey case, as to one of the taxpayers, used the estimated salvage value of $1,325 per car instead of the actual sales price of $1,380. Had the Supreme Court wished to declare the principle now urged by the Commissioner, it had every opportunity to do so merely by taking the actual sales price. However, it did not.

A thorough and well reasoned analysis of the depreciation problem is set forth in the trial court's decision in The Motorlease Corporation v. United States of America. 215 F.Supp. 356 (D.Conn. 1963). Although a panel of this court "On the authority of, and for the reasons given in Fribourg Navigation Co. v. Commissioner, 2d Cir., Docket No. 28165, decided today," reversed Motorlease, this case in reality supplies neither reasons nor authority. Motorlease reaches its result by saying "neither the Code nor the regulations are dispositive of the issue." To ignore the tax law as clearly written and the interpreting regulations is quite essential to a decision in contravention of such laws. This court in Motorlease does not believe that the transmutation of ordinary income into capital gains should be encouraged. Here is another example of the judicial enactment of a law which Congress itself over a long period of years had rejected. As pointed out in Evans v. Commissioner, 264 F.2d 502, 513 (9th Cir. 1959), rev'd on another ground sub nom. Massey Motors, Inc. v. United States, 364 U.S. 92, 80 S.Ct. 1411 (1960), "The legislative history of section 117(j) shows that Congress [had] not receded from its original purpose. Congress was aware of the Commissioner's contention that taxpayers were converting into capital gains ordinary income arising from unreasonable deductions for the depreciation." After reviewing various legislative attempts to have gain treated uniformly as ordinary income the court added tersely, "The recommendation was heard but not adopted." 264 F.2d 514.

In Motorlease the Commissioner did what he did not do in Massey. He took sale price as a new and substituted salvage price value despite the specific requirement that it was to be "determined at the time of acquisition." Thus Motorlease as decided by this court in substance and actuality goes contrary to the decisions of the Supreme Court in Massey and Evans.

The factual distinction which makes Fribourg, even as the majority decide it, completely inapplicable to Motorlease, is that Fribourg admittedly does not deal with a business which consisted of short time use of property and its sale before the expiration of its physical life. Motorlease was analogous to, and should have been controlled by, Massey, Evans and Hertz. Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein.

Another series of illuminating beacons the light of which is more than adequate to reveal the right path are recent district court cases from other circuits.

In Wyoming Builders, Inc. v. United States, 227 F.Supp. 534, D.C.D.Wyo., the court was confronted with a refund case involving the disallowance of depreciation on property sold two months before the close of the taxpayer's fiscal year (November 1, 1957—October 31, 1958). The property, an Air Force base housing project, had been set up on a seventy-five year lease basis, all improvements to remain the property of the government upon expiration or termination. When the property was sold to the government in 1958, the taxpayer, as here, reported as a capital gain the difference between the sale price and the cost less eight years' depreciation. The court considered the applicable statutes and regulations as well as the Cohn case and concluded that the government's theory that no depreciation occurred in the year of sale was untenable, saying in part:

> "Depreciation occurs by use; the use of the property by the taxpayer until September 1, 1958, when the sale took place, resulted in a continued depreciation of the property until September 1, 1958. The expense of using the property was properly allocated by the taxpayer to the period of time which was benefited by that asset, that is, from the beginning of the fiscal year in issue until the date of the sale. Depreciation is the measure of the cost of that part of the assets which has been used up or gradually 'sold' through wear and tear." United States v. Ludey, 274 U.S. 295, 301, 47 S.Ct. 608, 71 L.Ed. 1054 (1927).

The conclusions of the court in Wyoming Builders are so consonant with the law that it is impossible to conjure up countervailing arguments. The court held that "Neither the law nor the regulations permit this court to substitute the term 'sale price' for the regulation's term 'reasonable salvage value'," and that "to sustain the disallowance of taxpayer's depreciation deduction would require an unwarranted judicial extension of the Code and Treasury Regulations." The court believed, as do I, that, if the law is to be changed, "Congress, not the Court, must enact adequate controls and set the standards."

The history of the Wier Long Leaf Lumber Co. case, 9 T.C. 990 (1947) and the Commissioner's acquiescence (1948-1962), his non-acquiescence (1962) and its affirmance and partial reversal on other issues, 173 F.2d 549 (5th Cir. 1949), is relevant here. The Tax Court held that the sale of depreciated automobiles did not preclude any depreciation allowance in the year of sale and that "mere appreciation in value due to extraneous causes [here the Suez situation] has no influence on the depreciation allowance, one way or the other.".

Kimball Gas Products Co. v. United States, 63-2 U.S.T.C. ¶ 9507, W.D.Tex. 1962 was brought for a refund for overpayment of taxes due to the Commissioner's disallowance

of depreciation in the year of sale (1959) of properties acquired in 1955 which for depreciation purposes had useful lives of seven years. The Commissioner disallowed one-half of the depreciation claimed in the year of sale. The court held that the taxpayer was entitled to the full depreciation and a tax refund.

The taxpayer in S & A Company v. United States, 218 F.Supp. 677 (D.Minn., 1963), a company manufacturing and selling outboard motors, sold its land and depreciable assets on April 1, 1956 to a company which continued the business. It claimed deduction for depreciation from September 1, 1955 to April 1, 1956 in its 1955-1956 fiscal year. The issue framed there was identical with the issue here. The court reviewed in detail the history of the tax laws material to the subject, the Regulations, the Massey, Hertz, Cohn and Wier Long Leaf Lumber cases and came to the conclusion that the Commissioner improperly disallowed the deduction. In the course of its opinion the court pointed out the distinguishing features of the Cohn case (assuming it to be correct), namely, that although "a sale of an asset at the end of its useful life for an amount in excess of its undepreciated cost at the beginning of the year of sale will justify a redetermination of salvage value," it is equally clear that the Tax Court held that sale of assets prior to the end of "useful life" at a price in excess of undepreciated cost at the beginning of the year of sale does not justify a determination of salvage value because the excess of price over cost is mere appreciation in value.

Refutation cannot be found in saying that these are only district court decisions. They are decisions which apply the tax statutes as they were written and the Supreme Court cases for the principles expounded therein. They do not attempt to ascribe to Congress an intent not encated into law. Rather the legislative history has disclosed that Congress had been aware of the problem and had intentionally chosen not to act.

The fallibility of the majority opinion is that it completely ignores that law. The majority say "Because our income tax system is based on annual reporting * * * the proper amount of depreciation to be taken each year must depend on estimates." They should have taken notice of the statutory words requiring that salvage value be "determined at the time of acquisition"—of necessity, an estimate. They then interpret the Commissioner's claim to be that it is "unreasonable to follow an estimate when one knows that estimate is incorrect." To impute such a claim to the Commissioner is to imply that he is unable to read, understand and follow the specific provisions of the law under which he can always seek to rectify an incorrect estimate. Instead of pursuing such a remedy here, the Commissioner concedes the accuracy both of useful life and the salvage value "determined at the time of acquisition."

Finding no support in law for its position and forced to concede that "the increment in the Feuer's value resulted from a fortuity normally associated with capital gain," the majority satisfy themselves with the belief that "no injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it." Any such legal philosophy has the effect of writing depreciation allowances and depreciation as a matter of sound accounting out of the tax laws. Possibly they intend by their opinion to do so because under such circumstances they say "the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance." This approach can scarcely be reconciled with their comment that "If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods." It was for this very reason that the Regulation, § 1.167(c), provided that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of

changes in price levels." Of course, sales price can easily be compared with the depreciated cost at the beginning of the year. But there is no law or regulation which declares that in such event no depreciation shall be allowed if the sales price is higher. Therefore, because this decision seems to be completely at variance with the statutes and the applicable decisions, I must dissent.

Judgment

(Filed July 15, 1964)

Appeal from the United States District Court for the District of Connecticut.

This cause came on to be heard on the transcript of record from the United States District Court for the District of Connecticut, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed and that the action be and it hereby is remanded with a direction that summary judgment be entered in favor of the appellant in accordance with the opinion of this court.

APPENDIX B

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of Certain Methods and Rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations presented by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on Use of Certain Methods and Rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

Treasury Regulations on Income Taxes (1954 Code):

SEC. 1.167(a)-1. *Depreciation in general.*—(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over

which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the deter-

mination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been subtsantially exhausted salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

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SEC. 1.167(a)-8. Retirements—(a) *Gains and losses on retirements.* For the purposes of this section the

term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

* * * * *

SEC. 1.167(a)-10. When depreciation deduction is allowable. (a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section

167 (b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service.

* * * * *

SEC. 1.167(b)-0. Methods of computing depreciation.—(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

* * * * *

SEC. 1.167(b)-1. Straight line method.—(a) *Application of method.* Under the straight line method the cost or other bases of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the

property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For conveniense, the allowance, so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

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No. 24

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

THE MOTORLEASE CORPORATION, *Petitioner*

v.

UNITED STATES OF AMERICA

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 685

THE MOTORLEASE CORPORATION, *Petitioner*

v.

UNITED STATES OF AMERICA

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

In our petition for a writ of certiorari, filed on November 13, 1964, we referred (Pet. 22) to cases then pending in other Circuits which presented the same issue as that involved in this case. Among them was *United States* v. *S & A Company*, pending in the United States Court of Appeals for the Eighth Circuit. The purpose of this supplemental memorandum is to advise the Court that on November 27, 1964, the Eighth Circuit decided the *S & A Company* case in favor of the taxpayer, in a decision in direct conflict with the decision of the court below in this case. The Eighth

Circuit's opinion, together with the dissenting opinion of Judge Van Oosterhout, is set forth in full in the Appendix (pp. 1a-32a) to the Supplemental Memorandum in Support of Petition for a Writ of Certiorari in *Fribourg Navigation Company, Inc.* v. *Commissioner*, No. 679, this Term, filed in this Court on December 8, 1964.

In the *S & A Company* case, the taxpayer, engaged in the business of manufacturing and marketing outboard motors, sold all of its operating assets at a price exceeding not only their adjusted basis at the beginning of the year of sale, but also their original cost. The question in the case was whether the taxpayer was "entitled to any deduction for depreciation on the sale assets in the sale year" (Supp. Mem. in *Fribourg,* No. 679, p. 1a). The reasonableness of the amount of depreciation claimed, if allowable at all, was, as in this case, not in dispute. *Id.* at 5a.

The Eighth Circuit held that the claimed depreciation deduction was properly allowable under section 167 of the Internal Revenue Code of 1954 and the regulations thereunder. The court held that, where the estimates of useful life and salvage value are reasonable and unchallenged, a sale at a price exceeding book value at the beginning of the year-of-sale does not require disallowance of the depreciation deduction for the year-of-sale. In so holding, the court stated (Supp. Mem. in *Fribourg*, No. 679, p. 24a): "There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year. The emphasis, as has been noted, is, instead, on the estimate of

salvage value, on such estimate at acquisition, or (sic) redetermination as the exception, on the distinct possibility of gain or loss on disposition, and on divorcement of salvage value from price level fluctuations."

Although the court expressed "deep respect for the conclusions reached by the Second Circuit majorities in *Fribourg* and *Motorlease*" (Supp. Mem. in *Fribourg*, No. 679, p. 29a), it refused to follow those decisions disallowing the claimed deductions for the year of sale.[1] Judge Van Oosterhout stated, in his dissent, that he agreed with the interpretation of the statute and regulations made by the Second Circuit in the *Fribourg* and *Motorlease* cases, and that he "would reverse upon the basis of the majority opinions in such cases" (Supp. Mem. in *Fribourg*, No. 679, p. 32a).

The decision of the Eighth Circuit in the *S & A Company* case is in direct conflict with the ruling of the court below that a taxpayer may not "take a depreciation deduction for the year of sale of a depreci-

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[1] The Eighth Circuit noted that the sale involved was "an unanticipated sale in midlife", rather than "at or near the very end of useful life in the taxpayer's hands". In the latter case, the court observed, "there *may* be justification in a given case for the disallowance of final year depreciation, "although this would require "something more than the mere happenstance of a favorable sale price". (Supp. Mem. in *Fribourg*, No. 679, p. 26a). Emphasis Added. While we do not concede the validity of the distinction based on the time of disposal, it is clear that the court was not attempting to distinguish the case before it on the one hand from *Motorlease* and *Fribourg* on the other, or to draw any distinction between *Motorlease* and *Fribourg* themselves. The court noted that "It does not follow * * * that a favorable sale at the end of useful life compels a depreciation disallowance in all cases" (Ibid.), and the *Fribourg* and *Motorlease* decisions were treated together throughout the Eighth Circuit opinion. See Supp. Mem. in *Fribourg*, No. 679, pp. 2a, 13a-14a, 15a, 27a, 29a, 30a.

able asset in excess of the amount by which the adjusted basis of the asset at the beginning of the year of sale exceeds the amount realized upon the sale" (Petition for Writ of Certiorari in this case, Appendix A, p. 1a).[2] We respectfully submit that the petition for a writ of certiorari should be granted, not only for the reasons already set forth in our petition, but also to resolve this conflict of decisions between the Second and Eighth Circuits.

Respectfully submitted,

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[2] Since the filing of the petition in this case, there have also been two additional decisions allowing, contrary to the decision below, a depreciation deduction in the year of sale of assets at a gain. *Occidental Loan Co.* v. *United States*, 14 AFTR 2d 5911 (S.D. Cal., Nov. 13, 1964); *Holder Drive-Ur-Self, Inc.* v. *Commissioner*, 43 T.C. No. 19, Nov. 20, 1964.

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 685

THE MOTORLEASE CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE UNITED STATES

This case involves the same basic issue as is presented in *Fribourg Navigation Co.* v. *Commissioner*, No. 679. For the reasons stated in the Commissioner's memorandum in that case, we believe that the writ should also be granted in the instant case.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

JANUARY 1965.

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